COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF CALVERT INVESTMENTS INC., FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE PROCEDURE FOR SMALL UTILITIES	))) CASE NO. 8761)

O R D E R

On January 24, 1983, Calvert Investments, Inc., ("Calvert") filed its application with this Commission to increase its rate pursuant to 807 KAR 5:076, Alternative Rate Adjustment Procedure for Small Utilities ("ARF"). The proposed rate would produce additional revenue of $60,205 annually, an increase of 92 percent. The Commission finds herein that no deficiency exists in the revenues of Calvert and has, therefore, allowed no increase in revenues.

Public hearings were held in this matter on March 30, and April 22, 1983, in the Commission's offices in Frankfort, Kentucky. The Consumer Protection Division of the Attorney General's Office as well as a group of "Users of Calvert Investments, Inc., Sewage Treatment System," represented by the City of Minor Lane Heights and the City of South Park View ("Customers") were permitted to intervene.

At the hearing held on March 30, 1983, counsel for Customers moved the Commission to dismiss the case based on the ground that the notice of rate increase sent by Calvert to its customers was not in compliance with KRS 278.185 and 807 KAR 5:076, Sections 3 and 4. The motion was filed on April 18, 1983. Calvert filed a response to the motion on April 22, 1983. The motion alleges that the notice mailed to customers on February 7, 1983, does not meet the requirements as to the method of dissemination set forth in 807 KAR 5:076, Section 3. That regulation specifically exempts sewer utilities from those dissemination requirements because KRS 278.185 mandates that direct mail notice be provided by Calvert.

The motion further alleges that the February 7, 1983, notice does not contain the information required by 807 KAR 5:076, Sections 3 and 4. Calvert admits that its February 7, 1983, notice did not contain the requisite information but argues that a subsequent notice containing the information was mailed to each customer on March 9, 1983. The Commission has reviewed both notices and is of the opinion that Calvert has substantially complied with the notice requirements. Therefore, the motion to dismiss lacks merit and is hereby denied.

COMMENTARY

Calvert is a privately-owned sewage treatment system organized and existing under the laws of the Commonwealth of Kentucky, and serving 606 customers in Jefferson County.

TEST PERIOD

The Commission has adopted the 12-month period ending December 31, 1981, as the test period for determining the reasonableness of the proposed rate. In utilizing the historical test period, the Commission has given full consideration to known and measurable changes found reasonable.

REVENUES AND EXPENSES

The ARF was established to provide a simplified and less expensive method for small utilities to use in applying for rate increases with the Commission. Therefore, the financial data from the 1981 Annual Report is used as the basis for determining the revenue requirements. Calvert did not propose any adjustments to its test period revenues and expenses; however, the Commission has made several adjustments to Calvert's test period operating statement to reflect actual and anticipated operating conditions.

Management Fee

Calvert's operating expenses for the test period include a $3,000 management fee. The Commission has reviewed the duties and responsibilities of Ms. Florence Calvert, owner of Calvert, and as they are similar to the duties performed by the owner/operator of similarly sized utilities who receive fees of approximately $1,800, has allowed a fee of $1,800 in this case. Therefore, an adjustment has been made to reduce the test year expense by $1,200.

Electric Expense

Calvert incurred test period electric expense of $9,628. In order to assess the accuracy of the reported level of expense, as well as to determine the adjusted electric expense, the Commission requested and Calvert has supplied a summary of its test period monthly electric usage from Louisville Gas and Electric Company. In calculating the adjusted electric expense the Commission has applied the current rates in effect to the actual KWH used by Calvert during the test year. This results in an adjusted electric expense of $10,612.

Family Employment

Calvert accrued $8,120 of expense related to the employment of relatives of the owner during the test year. Calvert has accrued the $8,120 expense annually as well as Ms. Calvert's office salary of $6,400 per year since 1977. The accumulated accrued expenses are recorded in Account 232, Accounts Payable, and total $72,600 at December 31, 1981.

Calvert asserts that the $8,120 represents salaries of Ms. Calvert's children for maintenance work performed by them during the test year. Duties varied depending upon the degree of skill necessary.

At the hearing held in this matter Ms. Calvert testified that no documentation exists in support of these expenses, and there are no written contracts with the family members. In this instance the transactions between Ms. Calvert's children and the utility are at less than arms-length as Ms. Calvert is the sole owner of the utility. To evaluate transactions of this nature the Commission must be provided with adequate evidence in support of the transactions. In this instance no written documentation or other evidence has been provided in support of these accruals. In addition, both Ms. Calvert and Calvert's CPA testified that a schedule submitted by Calvert showing for each family member the hours worked and wage rate per hour was prepared by memory several years after these expenses began to accrue. It is the Commission's opinion that Calvert has not meet its burden of proof in regard to the $8,120 of family employment charged to expense. Therefore, the Commission has removed this expense for rate-making purposes herein.

Extraordinary Maintenance

Ms. Calvert testified that during the test period a breakdown at the treatment plant caused a backup of sewage into the field next to the treatment plant. The Jefferson County Health Department ordered Calvert to clean up the field and Calvert subsequently hired a vacuum truck to do so. The cost of the cleanup was $1,141 and was reported by Calvert in Account 701, Labor and Expenses. The Commission has reviewed this expense and is of the opinion that it should not normally occur on an annual basis, and should be amortized over a reasonable period of time. Therefore, the Commission has reduced Account 701 by $1,141 and included amortization expense of $380 to amortize this cost over a 3-year period for rate-making purposes.

Other Labor Materials & Expenses

During the test period Calvert installed a new diffused air system at the treatment plant at a cost of $3,103 which was included as an operating expense during the test period. The Commission finds that the cost of the diffused air system should be capitalized and depreciated over its estimated useful life. Therefore, the Commission has reduced Account 701-C, Other Labor, Materials & Expenses, by $3,103 for rate-making purposes.

The Commission finds that the estimated useful life of the diffused air system should be 3 years and has adjusted depreciation expense to reflect one-third of the total cost of this item.

Routine Maintenance Expense

Calvert incurred monthly expenses of $400 during the test year for the employment of a routine maintenance service company. Subsequent to the close of the test year Calvert changed service companies and now pays $800 per month for routine maintenance. Ms. Calvert testified that the change was necessary due to the poor performance and lack of preventative maintenance done by the previous maintenance firm. The Commission has reviewed the contract with the new service company and is of the opinion that the increased cost incurred to secure adequate plant maintenance is not unreasonable and should be allowed. Therefore, the Commission has increased Calvert's routine maintenance expense by $4,800 to reflect the increased cost.

Transportation Expense

Calvert reports test period transportation expense of $2,400. Ms. Calvert testified that during the test period she traveled to the treatment plant daily to oversee operations due to the poor daily maintenance being performed by the service company. However, Ms. Calvert testified that subsequent to the change in service companies and the corresponding increased level of operating efficiency she currently travels to the treatment plant only once a week. Therefore, the Commission has reduced Calvert's transportation expense by $2,046 to reflect the cost of travel to the treatment plant once a week.

Salary Expense

Calvert accrued $6,400 during the test period relating to Ms. Calvert's office salary as discussed in a previous adjustment. In support of this level of expense Ms. Calvert testified that as the sole employee of Calvert she performed all clerical as well as office duties, including payment of bills and recordkeeping. The Commission has reviewed these duties and finds that while they do overlap somewhat with Ms. Calvert's duties as manager for which she has been allowed a management fee, they are somewhat greater in scope than the duties of most owner/operators. However, the Commission does not believe that the duties performed justify a salary of $6,400. Therefore, the Commission finds that a salary of $1,200 is not unreasonable for the services performed and has reduced Calvert's salaries expense accordingly herein.

The increased level of routine maintenance expense allowed herein, which is for the purpose of ensuring proper and timely preventative maintenance, should result in an increased level of operating efficiency and a reduction in the frequency of equipment breakdowns and therefore relieve the owner/operator of a substantial portion of the work involved in arranging for frequent repairs and overseeing daily operations of the utility. The Commission has considered the positive effect that increasing the routine maintenance service fee will have upon operating efficiency and the corresponding reduction in the workload of Ms. Calvert in establishing the office salary allowed herein.

Telephone Expense

Calvert has included in its test year operating expenses $720 of telephone expense reported in Account 721, Office Supplies & Other Expenses. The Commission in its Order of March 11, 1983, requested that Calvert provide copies of its telephone bills in support of its reported level of expense. Calvert provided an itemization of a telephone bill from South Central Bell showing a breakdown of its telephone expense. The itemization was not an itemization of Calvert's telephone bill but that of Calvert's CPA. Ms. Calvert testified that she has two residential telephones in her home for Calvert's use, one of which has an unlisted number. The Commission does not believe that an operation the size of Calvert requires two telephones or that Calvert's customers could derive any significant benefit from a telephone with an unlisted telephone number. Therefore, the Commission has reduced Calvert's telephone expense by $502 to allow only the cost of one residential telephone which the Commission finds reasonable in this instance.

The use by Calvert of estimated expenses in the annual report can not be condoned by the Commission. Utilities reporting to the Commission must follow the Uniform System of Accounts prescribed by the Commission and report to the Commission their actual cost incurred with minimal use of estimates. The Commission expects Calvert to report its actual expenses in all annual reports and financial data filed with the Commission with any exceptions appropriately identified.

Insurance Expense

Calvert reported insurance expense of $964 during the test period. At the request of the Attorney General, Calvert reviewed its insurance expense. Calvert reported that of the total expense, a payment of $389 made during the test period was not a corporate expense. Therefore, the Commission has reduced Calvert's insurance expense by $389 to exclude this expense for rate-making purposes.

Agency Collection Fee

Calvert incurred $6,512 of expense related to the collection of its bi-monthly sewer bill by the Louisville Water Company ("LWC"). Calvert currently has incremental rates based upon water usage and is billed accordingly by LWC. Calvert has requested in this case that it be granted a flat rate which the Commission allowed. Sewer utilities with flat rate monthly fees which utilize the billing services of LWC pay a portion of the joint service cost based on the ratio of the sewer bill to the combined water and sewer bill. Therefore, with the change to a flat rate Calvert will realize a considerable reduction in its collection expense. The Commission has computed Calvert's collection expense based upon the flat rate allowed herein. This results in an annual collection expense of $3,019.

Income Taxes

Calvert incurred income tax expense of $2,503 for the test period based upon net income per its 1981 tax return of $10,896. Calvert's 1981 annual report on file with the Commission shows a net loss of $6,127 including the income tax expense of $2,503. The inclusion of income tax expense based upon a net income figure used for tax purposes that differs from that reported in the annual report can materially distort the financial report and can not be accepted by this Commission. In the future Calvert must report its income tax expense based upon the income figure as reported in the annual report. The Commission has included a provision for income taxes of $1,399, based upon the level of net income allowed herein and the applicable federal and state tax rates.

Other Income

At December 31, 1981, Calvert had an accumulated balance of $76,239 in Account 141, Notes Receivable representing loans from Calvert to its owner. These loans are reported on Schedule L of Calvert's 1981 tax returns as "Loans to Stockholders." Ms. Calvert testified that each year for the past several years she has withdrawn monies from Calvert with these withdrawals being accounted for as loans from the corporation to her. No notes exist as documentation of these loans, and no interest has ever been paid on these loans.

The Commission in its request of February 13, 1983, required Calvert to file additional information concerning these notes. Calvert's response states in part, "if there had been enough revenue to satisfy the 12 percent return on investment, there would have been no receivable recorded." The Commission has a well-established policy of calculating sewer utilities' revenue requirements on an operating ratio and not a return on investment due to the difficulty of establishing an accurate rate base for most sewer utilities. In addition, Calvert's statement does not explain its failure to seek timely rate relief. The Commission's records indicate that Calvert last requested rate relief in 1975, 7 years before the filing of this case. When questioned about this, Ms. Calvert responded that she had received inquiries from various municipalities concerning the possible sale of the utility and had not requested rate relief for that reason. The Commission does not believe this is sufficient reason to delay a request for needed revenue. Prudent management would have pursued rate relief when the need arose.

It is clear to the Commission that the loans from the utility to Ms. Calvert have had a negative impact on Calvert. In the years during which these loans were made, Calvert fell 2 years behind on the principal payments on its long-term debt and is now currently paying only the annual interest. Had these loans not been made, or at a minimum, had interest been paid on the balance of the loans, funds would have been available for the principal payments and much of the additional interest expense which will be incurred could have been avoided. In addition, the removal of these funds from the corporation undoubtedly has reduced the amount of funds available to Calvert to finance needed repairs and maintenance.

The Commission is concerned about the negative impact of the loans and is of the opinion that Calvert's customers have not been well served by these transactions. In view of these circumstances the Commission has made an adjustment to include $7,624 of interest income in Calvert's operating statement to reflect a 10 percent return on the use of these funds. The Commission finds this level of interest to be a reasonable amount which could have been earned by Calvert had these funds been loaned to an outside party. Moreover, this level of interest income is representative of the avoided costs that could have been realized by Calvert if these funds had been used to repay the principal on its outstanding debt rather than to make loans to the owner.

The Commission finds that Calvert's adjusted test period operations are as follows:

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$65,174	$ -0-	$65,174
Operating Expenses	63,111	(19,101)	44,010
Operating Income	$ 2,063	$ 19,101	$21,164
Other Income	-0-	7,624	7,624
Other Deductions	8,190	-0-	8,190
Net Income	$(6,127)	$ 26,725	$20,598

REVENUE REQUIREMENTS

Calvert requested operating revenues sufficient to produce a 12 percent return on the replacement cost of plant in service at December 31, 1981. In determining the level of investment in plant devoted to public use for rate-making purposes, a well-established formula is used by this Commission. The rate of return is applied to the net investment rate base which is determined by adding materials and supplies, prepayments and working capital to the total utility plant in service and deducting accumulated depreciation and contributions in aid of construction.

The Commission has consistently used the operating ratio method[1] to determine the revenue requirements of privately-owned sewer utilities because of certain problems involved in arriving at a legitimate rate base. In this case the Commission finds that an operating ratio of 88 percent is fair, just and reasonable and will allow Calvert to pay its operating expenses, service its debt, and provide a reasonable return to its owners.

In this instance the use of an 88 percent operating ratio applied to the adjusted test year operating expenses results in a revenue requirement of $50,578 which is less than the actual test period revenues. Therefore, the Commission finds that no deficiency exists in the revenues of Calvert and has, therefore, allowed no increase in revenues.

SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that;

The rate proposed by Calvert should be denied.

IT IS THEREFORE ORDERED that the proposed rate in Calvert's application be and it hereby is denied.

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1 $$\text{Operating Ratio} = \frac{\text{Operating Expenses + Depreciation + Taxes}}{\text{Gross Revenue}}$$

Done at Frankfort, Kentucky, this 7th day of July, 1983.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary